PRESIMA

Either, Neither or Both?

The Case for Public AND Private Real Estate

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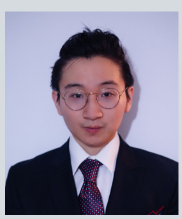

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Over the years, many studies have been written that allude to the benefits of adding publicly traded real estate securities to a mixed-asset portfolio. Just as many studies have been written that allude to the benefits of adding private real estate. The argument is similar yet different.

However, we believe and have observed that significant differences exist between the two. It could be viewed that private real estate has limited or next to no liquidity while shares of listed real estate companies trade daily on world stock exchanges. Although having liquidity provides a benefit to public real estate, the cost is higher volatility relative to private real estate. For those reasons, we have observed many asset allocators and their advisors have therefore preferred getting exposure to real estate via private channels.

Using the U.S as a proxy for sector exposure, private real estate (using the NCREIF Property Index) is largely made up of the four major "food groups" of office, apartments, industrial and retail. Public real estate (using the NAREIT Equity Index), on the other hand, is much more diverse, offering significant exposure to emerging property sectors to include health care, data centers, and self-storage.

Both public and private real estate have a large and growing universe of potential investments. We believe both offer significant diversification benefits relative to equities and bonds. Also, we see both having long-term attractive returns.

For those investors who gain their exposure to real estate exclusively through private channels, we believe that the price for doing so is giving up on greater sector diversification

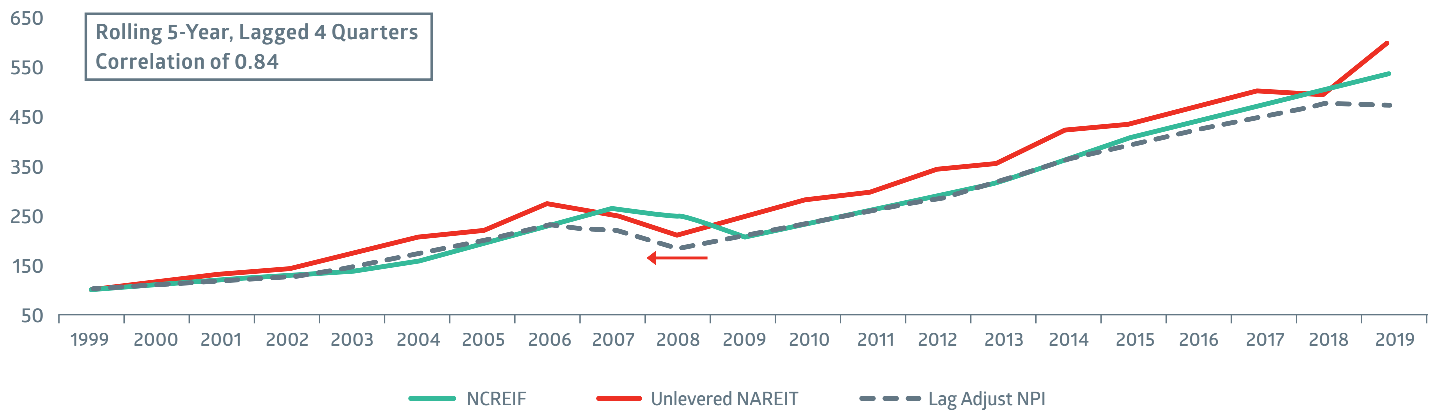
In the end, we believe it is not a decision about Private OR Public. In fact publicly traded real estate securities AND private real estate are two sides of the same coin and investors should consider both in their mixed-asset portfolio which is likely to offer greater sector diversification, liquidity and higher risk-adjusted returns than either approach by itself.

REAL ESTATE SECURITIES (REITS) ARE REAL ESTATE

To begin, over the years much has been written on this topic and perhaps an effective way of answering this question is to explore the relationship of private versus public real estate over time. Using quarterly total returns from the NPI Index (the NCREIF Property Index measures unlevered returns for institutionally owned core real estate in the United States and is based on property appraisals) as well as NAREIT total returns (U.S. REITs), we can examine the relationship between private and public real estate in the U.S. Exhibit 1 compares rolling 5-year returns from the NAREIT Equity Index with the NCREIF Property Index. Two adjustments were made to account for a lag in private market returns (four quarters in our analysis) and to account for the use of leverage (NCREIF returns are unlevered whereas NAREIT returns include leverage). Adjusting for these two factors, the correlations between private and public real estate returns is high at 0.84. This high correlation provides strong evidence that public and private real estate are very closely linked, despite differences in property sector exposure (explained later in this paper) and geography.

Exhibit 1: Relationship Between Private and Public Real Estate 2000-2019

NCREIF AND NAREIT RETURNS - 2000 TO 2019



Note: NAREIT Returns were unlevered to match unlevered NCREIF Property Returns. Sources: EPRA/NAREIT, NCREIF, Bloomberg L.P.

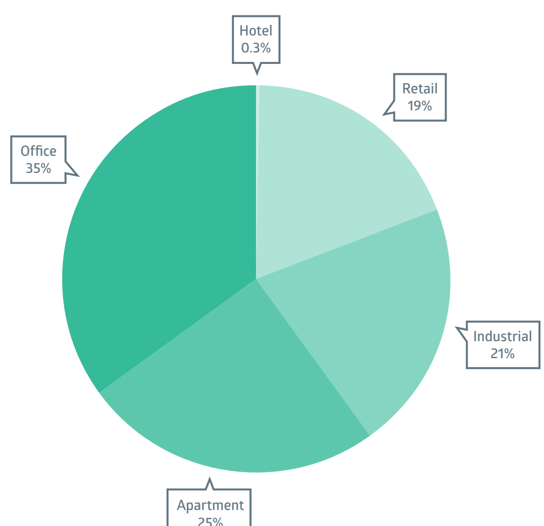
BOTH PRIVATE AND PUBLIC REAL ESTATE HAVE A LARGE INVESTABLE UNIVERSE

As of 3Q 2020, the NCREIF Property Index (NPI) has a market cap of $702 billion. The NPI is comprised almost entirely of the four major "food groups" or property types of office (representing 35% of the index), apartments (25%), industrial (20%) and retail (19%). Hotels, a fifth category, represents less than 1% of the index (Exhibit 2)[1].

The FTSE NAREIT All REITs Index has a market cap of $1.1 trillion as of 3Q 2020[2]. The property sector composition of the REIT Index is significantly different from the NPI (Exhibit 2). Whereas the four major "food groups" represent the entirety of the NPI, these same four groups make up less than 50% of the NAREIT Index. One of the most striking changes in the composition of the NAREIT Index over the past 20 years is the diversity of sectors now represented in the listed market. In 1997, the REIT market in the U.S. looked much like the NPI, being dominated by office, retail, industrial, and residential companies. Since then, many more product types have been added or expanded, including health care, data centers, self-storage, communication towers, movie theaters, and outdoor advertising sites.

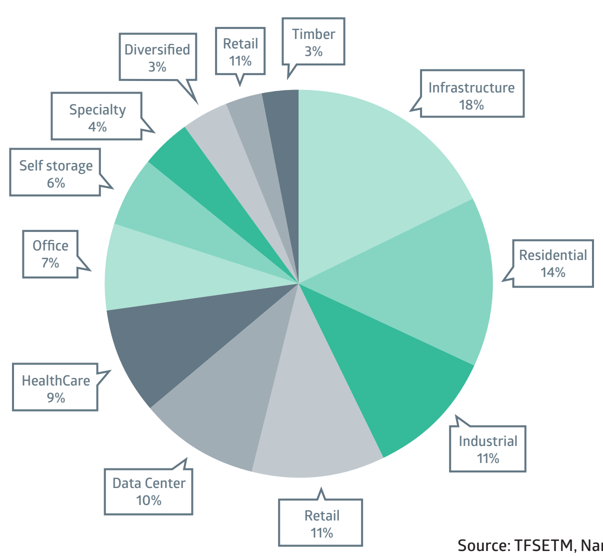
Exhibit 2: Composition of the NCREIF Property Index and FTSE NAREIT Property Index

MARKET CAPITALIZATION BY SUBSECTOR
(% OF NCREIF PROPERTY INDEX)



Source: NCREIF

MARKET CAPITALIZATION BY SUBSECTOR
(% OF FTSE NAREIT ALL EQUITY REITS)



Source: TFSETM, Nareit®

Much like private real estate with three major strategies of core, value-add and opportunistic, investors can buy shares of publicly listed real estate companies that own and operate real estate with little to no development exposure and low levels of leverage (core); companies that are looking to add value by redeveloping and re-tenanting their portfolios (value-add); and companies that have significant development capabilities and platforms (opportunistic). The bulk of publicly traded REITs in the U.S. are made up of "core" real estate holdings. Looking beyond the United States, publicly traded real estate companies can also provide exposure to developed, developing and emerging economies and countries.

PRIVATE AND PUBLIC LONG-TERM RETURNS ARE SIMILAR…OVER THE LONG TERM

Over the past 10 and 20 years, the returns between private and publicly listed real estate are similar.

Over a 10-year time horizon ending October 31, 2020, private real estate outperformed public real estate[3], generating average annual returns of 9.4% versus 8.1% for listed public real estate. However, over the past 20 years, listed real estate outperformed private real estate, generating an average annual return of 9.8% versus 8.4%[4]. So, whether an investor owns real estate in a private or public format, long-term returns tend to be stable and similar. Short-term, however, public and private real estate returns can vary significantly as publicly traded real estate companies tend to react quickly to changing market conditions, including capital flows, economic trends and property fundamentals. Private real estate returns, on the other hand, are based on appraisals which happen quarterly or annually, which result in significantly lower stated volatility.

PUBLIC AND PRIVATE REAL ESTATE RETURNS COMPARE FAVORABLY TO STOCKS AND BONDS

Over the past 20-years, it has been widely accepted by consultants and asset allocators that exposure to private real estate would provide risk-adjusted return benefits to the overall portfolio. The surge in demand for private real estate, as seen by the "wall of capital" phenomena, is an obvious illustration of this trend.

But many have reduced their exposure to public real estate to do so. Some also argue that public real estate exposure was made through broad equities exposure (S&P500 or MSCI World, for example). We believe investors should reconsider their exposure to broad equities (and bonds) and consider adding REITs, and not only to private real estate, to their mixed-asset portfolios.

Over the past 20 years, both private AND public real estate have outperformed U.S. stocks and bonds. Private real estate generated an average annual return of 8.4%; publicly listed real estate generated average annual returns of 9.8%; with the S&P 500 generating average annual returns of 6.1% and U.S. government bonds generating average annual returns of 4.9%. Public and private real estate even outperformed global equities, as measured by the MSCI World Equity Index, which generated an average annual return of 5.1% (Exhibit 3).

Exhibit 3: Long-Term Returns of Stocks, Bonds and Real Estate

20-YEAR AVERAGE ANNUL RETURN

NCREIF	NAREIT	S&P 500	US government bond	MSCI World
8,4%	9,8%	6,1%	4,9%	5,1%

Source: FTSEM, Nareit, NCREIF, Bloomberg L.P.

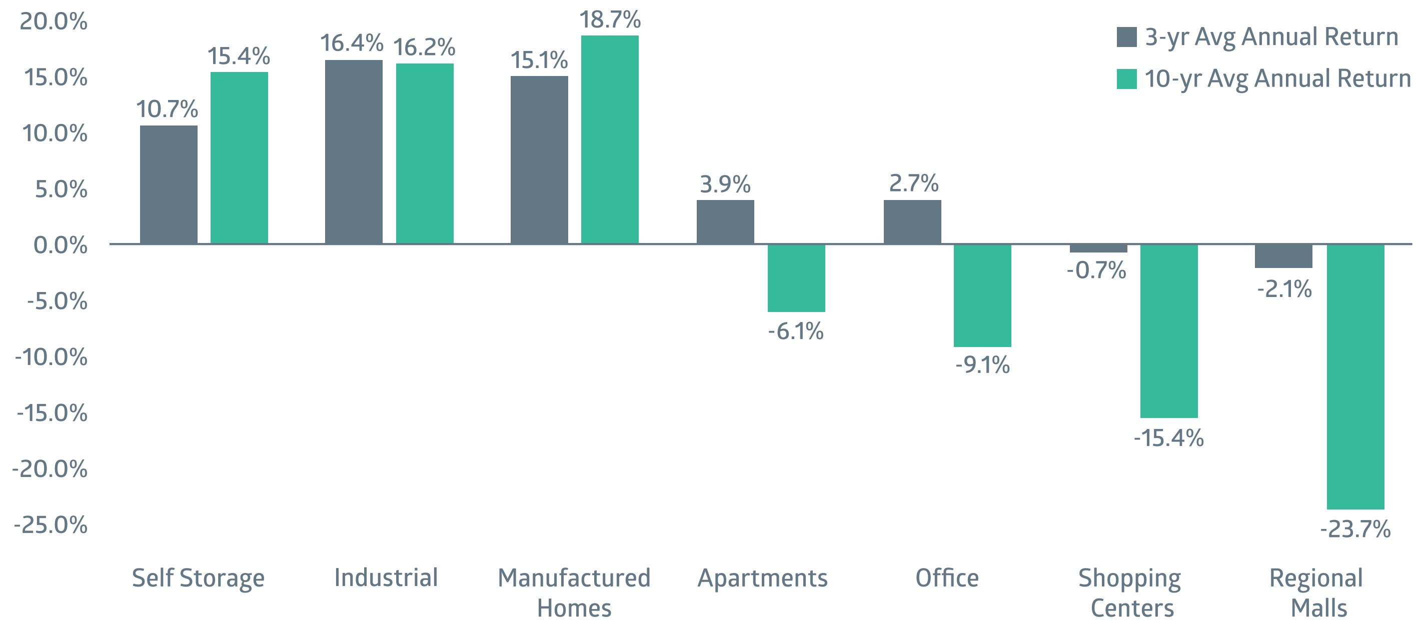
SPECIALTY SECTORS OFFER SOME OF THE BEST RETURNS AND RISK-ADJUSTED RETURNS

As illustrated previously, over the medium to long-term, some of the best performing real estate sectors have been those outside the four major categories. Using FTSE NAREIT Equity returns as our proxy, only one of the four major real estate categories, industrial, makes it into the top three sectors for risk-adjusted returns.

Over the last three years, the best performing sectors have been industrial (+16.4% average annual return); manufactured homes (+15.1%); and self-storage (+10.7%). Over the past ten years, manufactured homes take the first spot (+18.7% average annual return), followed by industrial (+16.2%), followed by self-storage (+15.4%)[5].

Exhibit 4: Relative Outperformance of Specialty Real Estate Sectors

3 & 10 YEAR AVERAGE ANNUAL RETURN



Note: 3-yr return (Oct 2017 to Oct 2020); 10-yr return (Oct 2010 to Oct 2020) / Source: FTSETM, Nareit®, Bloomberg L.P.

Office, retail (regional malls and shopping centers), and apartment returns over the same time horizons were materially lower than for those sectors quoted above (Exhibit 4). So, institutional investors who were overweighted in private real estate, or invested exclusively through private real estate, likely did not attain optimal returns in their real estate allocation (highest return for a given level of risk).

CONCLUSION

Both private and public real estate offer strong diversification benefits and attractive long-term returns relative to other asset classes. Institutional investors tend to invest more in private real estate versus publicly traded real estate companies, mainly due to volatility. Yet research demonstrates that real estate securities are real estate, and their long-term returns are similar to private real estate. Moreover, the composition of the FTSE NAREIT All REITs Index is much more diversified than the NCREIF Property Index, with more than 40% of the REIT Index made up of well-established specialty sectors. In fact, two of the best performing real estate sectors over the past 3 years, and even over the past 10 years, include manufactured homes and self-storage. For those institutions investing only in private real estate, they may have missed out on outsized returns coming from these specialty sectors. For these reasons and more (liquidity, market transparency, attractive dividends), institutional investors should have a meaningful allocation of publicly traded real estate in their overall real estate portfolio.

References

(1) https://www.ncreif.org/data-products/property/

(2) Source: FTSETM, Nareit®. Implied market capitalization is calculated as common shares outstanding plus operating partnership units, multiplied by share price. Data presented in thousands of dollars. The FTSE Nareit US Real Estate Index Series (Indexes) is calculated by FTSE International Limited (FTSE®), which is part of the London Stock Exchange Group plc (LSE Group). FTSE Russell® is a trading name of FTSE®, FTSE® and related trademarks and service marks owned or licensed to the LSE Group. Nareit® is the exclusive registered trademark of the National Association of Real Estate Investment Trusts®. All rights in the Indexes vest in FTSE® and Nareit®. All information is provided for information purposes only. Every effort is made to ensure that all information given in this publication is accurate, but no responsibility or liability can be accepted by any member of the LSE Group nor by Nareit® nor by their respective directors, officers, employees, partners or licensors for any errors or for any loss (including in negligence) from use of this publication or any of the information or data contained herein. Past performance is no guarantee of future results. Charts and graphs are provided for illustrative purposes only. Index returns shown may not represent the results of the actual trading of investable assets.

(3) Bloomberg L.P.

(4) Ibid.

(5) Ibid.

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